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City Club Research Study: Oregon State Ballot Measures 91 and 88 -- Deductibility of Federal Income Taxes

City Club of Portland (Portland, Or.)

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City Club Research Study

Ballot Measures 91 and 88—Deductibility of Federal Income Taxes

Committee Urges "NO"on 91—"NO" on 88

Your Committee Found:

Having succeeded in capping property taxes, anti-tax activist Bill Sizemore has turned his attention to state income taxes with Ballot Measure 91. The measure would make federal income taxes fully deductible in calculating Oregon personal income tax liability—currently federal taxes in excess of $3,000 cannot be deducted. Measure 91 would also permit full deductibility of federal income taxes on Oregon corporate income tax returns—currently corporations cannot deduct any federal income tax in calculating their Oregon corporate income tax. Your Committee found that Measure 91 would provide a massive tax cut for wealthy Oregonians with little or no benefit for lower and middle income taxpayers, would make the Oregon income tax regressive, would certainly require substantial cutbacks in essential state services, would further shift the tax burden from businesses to individuals, and would clutter the Oregon State Constitution with detail better left for statutes.

In reaction to the Sizemore initiative—not in response to any particular need or demand from the electorate—the Oregon Legislature referred Measure 88 to voters. Instead of removing the $3,000 cap on deductibility of federal income taxes for individual taxpayers, this measure would increase the limit from $3,000 to $5,000 and would index it for inflation. It would not affect corporate taxpayers. While Measure 88 would not have the dramatic impact on state resources that Measure 91 would have, your Committee found that even modest income tax cuts are not supportable given current budget priorities and reductions (in real terms) in property tax collections. In addition, as with Measure 91, Measure 88 leaves poorer Oregonians out of the tax cut, a fairness issue of great importance to your Committee.

Accordingly, your Committee unanimously recommends a "NO" vote on Measure 91 and a "NO" vote on Measure 88.

The City Club membership will vote on this report on Friday, October 13, 2000. Until the membership vote, the City Club of Portland does not have an official position on this report. The vote outcome will be reported in the *Bulletin* dated October 27, 2000.

I. INTRODUCTION

Ballot Measure 91 will appear on the ballot as follows:

Caption:	Amends Constitution: Makes Federal Income Taxes Fully Deductible on Oregon Tax Returns
Result of "Yes" Vote:	"Yes" vote makes federal income taxes fully deductible on Oregon personal, corporate income tax returns.
Result of "No" Vote:	"No" vote retains current system limiting federal income tax deduction on Oregon income tax returns.
Summary:	Amends Constitution. Under current Oregon law, personal income tax payers, including individuals, may deduct money paid in federal income tax; deduction generally limited to $3000. Currently, corporations paying Oregon income tax get no deduction for federal income tax. Measure makes all federal income tax paid by personal and corporate income taxpayers a deduction on the taxpayers' Oregon income tax returns. Applies only to federal income taxes on income subject to Oregon taxation. Measure effective in tax years starting on or after January 1, 2000.

(The language of the caption, question, and summary was prepared by the Attorney General of Oregon.)

Ballot Measure 88 will appear on the ballot as follows:

Caption:	Increases Maximum Deductible in Oregon for Federal Income Taxes Paid
Result of "Yes" Vote:	"Yes" vote increases maximum deductible on Oregon income tax returns for federal income taxes paid.
Result of "No" Vote:	"No" vote retains current cap on amount deductible in Oregon for federal income taxes paid.
Summary:	Under current Oregon law, taxpayers may deduct up to $3,000 on their Oregon income tax returns for federal income taxes paid; spouses filing their Oregon tax returns separately may deduct up to $1,500. Measure would increase those amounts to $5,000 and $2,500, respectively. Applies to tax years beginning on or after January 1, 2002. Requires cost of living adjustment for calendar years beginning on or after January 1, 2003. Provides no replacement funds and reduces revenues available for general government expenditures.

(The language of the caption, question, and summary was prepared by the Attorney General of Oregon.)

Measure 91 would significantly alter the character of Oregon's tax system and reduce state income tax revenues. Measure 88 is an alternative proposed by the Oregon Legislature. While both measures would change the deductibility of federal income taxes, their elements and impacts are quite different. The City Club created our committee to examine both measures and recommend positions on the measures to the City Club general membership.

City Club screened committee members for conflicts of interest to ensure that no member had an economic interest in the outcome of the study or was publicly identified with an existing position on the study topic. Committee members met weekly from August until the middle of September. Committee members interviewed Measure 91 and 88 proponents and opponents and staff of the Legislative Fiscal and Revenue Committees. The Committee also reviewed relevant articles, reports, and other materials.

What would Measures 91 and 88 Do?

Measure 91 is a citizen initiative that was filed by anti-tax activist Bill Sizemore. Measure 91 would amend the Oregon Constitution and allow Oregon taxpayers to deduct the full amount of their federal taxes on their state personal income tax return. State tax law currently limits this deduction to a maximum of $3000. Measure 91 would allow corporations to deduct all of their federal income tax on their state tax returns. Under current state law, corporations are not allowed to deduct any federal income tax on their state corporate income tax returns.

Measure 88 was referred to voters by the 1999 Oregon Legislature in response to Mr. Sizemore's filing of Measure 91. Measure 88 would amend existing state statute to increase the $3,000 limit to $5,000 for personal state income taxes. The measure would also require regular adjustments to the limit to compensate for inflation. Measure 88 affects only personal income tax returns. The measure does not change state law related to corporate income tax return.

II. BACKGROUND

A. Overview of Oregon's Tax System

Although a complete description of the Oregon tax system is beyond the scope of this report, your Committee believes that a meaningful analysis of Measures 91 and 88 requires a basic understanding of the structure of the state income tax and the primary sources and uses of state tax revenues.

Oregon's Income Tax

The state income tax has been a consistent source of state revenue since 1930.

From the tax's inception through 1974, Oregon taxpayers could deduct the full amount of their federal income taxes on their personal state income tax return. Corporations have never been allowed to deduct federal income taxes on their Oregon income tax returns. In 1974, the Oregon Legislature adopted a $3000 limit on the deduction of federal income taxes. In subsequent years, the legislature raised the limit to $5000 and then to $7000.

In 1986, the U.S. Congress completed an extensive revision of the Federal tax code. In 1987, the Oregon Legislature followed suit and broadened Oregon's tax base, increased the standard deduction, reduced the number of tax brackets from seven to three, reduced marginal tax rates, and lowered the federal tax deduction limit to $3000. Oregon income tax rates—and the limit on the deduction of federal taxes—have remained unchanged since 1987.

Sources of Oregon Tax Revenues

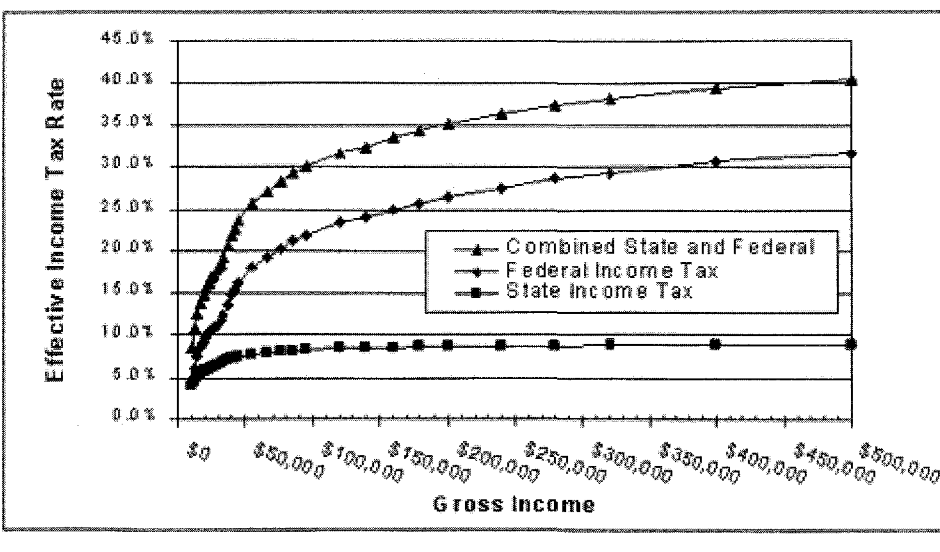
The income tax is the largest source of general state revenue in Oregon. The property tax is the largest source of local government revenue. Oregon does not have a general sales tax.

Personal Income Tax. Perhaps the most salient feature of the Oregon tax system is its reliance on the personal income tax as a source of general fund revenue—largely due to the absence of a broad-based sales tax. Personal income tax revenues comprise approximately 80 percent of general fund revenues. In the 1997-99 biennium, estimated personal income tax collections totaled approximately $7.1 billion (compared to $539 million for corporate income taxes).

Oregon's state income tax is relatively flat compared to the much more progressive federal income tax. Progressiveness in the state income tax is found mostly at lower income levels because those taxpayers have a larger portion of their income subject to the 5 percent and 7 percent marginal tax rates. Taxpayers begin paying the highest tax rate of 9 percent at low levels of income ($5,800 for a single return and $11,600 for a joint return). The structure of the current state and federal tax system is illustrated in Figure 1, which shows effective state and federal income tax rates for a single filer.

Corporate Income Tax. The corporate income tax is a smaller source of governmental revenues in Oregon than the personal income tax. The corporate income tax rate is a flat 6.6 percent. Although subject to fluctuation, corporate income tax receipts are typically about one-tenth of personal income tax receipts in any given year. Federal income taxes are not deductible on Oregon corporate tax returns. The corporate income tax accounts for slightly less than 10 percent of General Fund revenues.

Figure 1: Current Effective Income Tax Rates for Various Income Levels



Property Tax. In addition to the personal income tax, the other large source of government revenue in Oregon is the property tax. As recently as 1992-93, property tax receipts outpaced income tax receipts by a small margin. Property tax limitations approved by voters in recent years have effectively constrained property tax revenues. Since 1993-94, income tax receipts have surpassed property tax receipts and continue to outpace property taxes as a source of governmental revenue. In the 1998-99 fiscal year, personal income tax receipts were $1.2 billion greater than property tax receipts.

Property tax collections since 1990 have remained virtually flat ($2.4 billion in 1990; $2.5 billion in 1999) and have decreased in inflation-adjusted terms, without taking into account a 16 percent increase in Oregon population over that same period.

<u>**Uses of Oregon Tax Revenues**</u>

General Fund. Personal and corporate income taxes are paid into the state's General Fund. The General Fund comprises slightly more than a quarter of the state's "all funds" budget. Other major components of the state's budget are the Public Employees Retirement System, roads and transportation, unemployment benefits, prison construction, economic development, the federally-funded portion of the Oregon Health Plan, and veteran loan program. These programs generally are financed with non-fungible funds, such as dedicated bonds or earmarked federal funds. Accordingly, most of the discretionary spending in the state budget occurs in the General Fund.

The largest expenditures from the General Fund are for K-12 education (42.9 percent), human services (21.5 percent), community college and higher education (14.8 percent), and public safety (14.6 percent). The fastest growing General Fund expenditures are those for schools, the Oregon Health Plan, and public safety. Restrictions on property taxes have limited funds available to local governments for school funding, and shifted the financial responsibility to the state's General Fund. Health care inflation is the primary driver of increased costs for the Oregon Health Plan. Increased prison populations, partly due to stricter sentencing laws passed by voters, have caused increases in public safety costs. A reduction in income tax receipts would likely cause cuts in these programs, because other funds in the state budget generally cannot be transferred to make up shortfalls in the General Fund.

B. Evolution of the Federal Tax Deduction in Oregon

Between 1959 and 1974, Oregon voters voted on three broad tax reform packages passed by the Oregon Legislature. Each of these packages included a proposal to limit the deductibility of federal taxes on state personal income tax returns. Voters rejected each of the packages. In 1974, the legislature limited the deduction to $3000 and subsequently raised the limit to $5000 and then to $7000. In 1980, the legislature referred another broad tax reform and relief package to voters that included a provision to lower the limit to $3000. Voters overwhelming approved the package. The limit has not been changed since.

This evolution is described in more detail below:

- From 1930 to 1974, Oregon taxpayers could deduct the full amount of their federal income taxes on their state personal income tax returns.

- In 1959, the Oregon Legislature passed legislation that lowered tax rates and eliminated federal tax deduction (HB 670). The legislation was an attempt to increase state revenue partly to compensate for an anticipated budget shortfall. The shortfall never materialized. HB 670 was referred to voters by citizen referendum petition (1960 Measure 14). Oregon voters rejected Measure 14 (YES-17 percent to NO-83 percent).

- In 1973, the Oregon Legislature referred Governor McCall's School Finance Plan to voters (1973 Measure 1). One element of this complex proposal was a $2000 limit on the federal income tax subtraction. Oregon voters rejected 1973 Measure 1 (YES-41 percent to NO-59 percent).

- In 1974, the legislature tried again, and referred another tax reform/school funding proposal to voters (as 1974 Measure 1). Measure 1 would have increased personal income tax rates, increased state funding for schools, and limited the federal tax deduction to $3000. Oregon voters rejected 1974 Measure 1 (YES-25 percent to NO-75 percent).

- In 1974, after the defeat of Measure 1, the legislature passed a separate, one-year $3000 limiton the federal tax deduction. In 1975, the legislature raised the limit to $5000 and made it permanent. In 1979, the legislature temporarily increased the limit to $7000.

- In 1980, voters approved a complex tax reform proposal referred to the ballot by the Oregon Legislature (1980 Measure 5). The proposal made permanent the $7,000 limit on the federal tax deduction. 1980 Measure 5 also limited property tax assessments, provided property relief for people with low incomes, home owners, and renters, reduced the personal income tax, and instituted a state spending limit and a revenue limit (the "kicker"). Voters overwhelmingly approved 1980 Measure 5 (YES 91 percent to 9 percent NO).

- In 1987, the legislature reworked Oregon's income tax system in response to a significant reform of the federal tax system. As part of this reform, the legislature limited deduction of the federal tax to its current level of $3,000.

Real Value of the Federal Tax Deduction

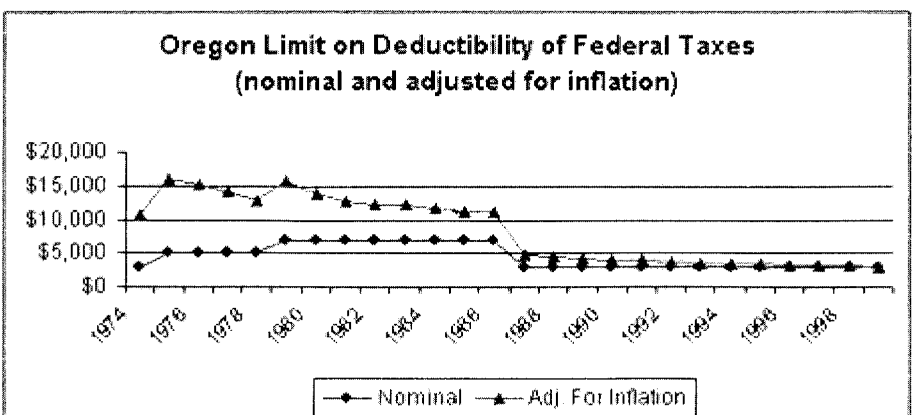
The real (inflation adjusted) value of the federal tax deduction has dropped significantly since it was first adopted in 1974. Figure 2 below compares the real value of the deduction (in constant 1999) dollars to the nominal value. In 1974, a nominal $3000 limit meant that taxpayers could deduct up to the equivalent of $10,000 federal tax in current dollars. Unless the limit is regularly adjusted for inflation, its value will continue to shrink over time.

C. Comparison with Other States

Currently 43 states and the District of Columbia have a personal income tax. Four states (Alabama, Iowa, Louisiana, and Montana) allow full deductibility of federal taxes on state returns. Oregon, Missouri, and Utah allow a partial deduction of federal taxes. North Dakota and Oklahoma allow taxpayers to choose whether to deduct federal taxes, but these states apply a different tax rate for taxpayers who elect to deduct federal taxes on their state returns. The remaining 34 states and the District of Columbia do not allow any federal tax to be deducted in determining state taxable income.

According to the nonpartisan Tax Foundation, Oregon is more dependent than any other state on the personal income tax as a source of governmental revenue. This heavy dependence on the income tax and the lack of a sales tax (usually a regressive tax) makes Oregon's overall tax system one of the more progressive in the country. Oregon's state and local tax burden, relative to other states, has dropped dramatically in recent years. Oregon's Legislative Revenue Office (LRO) reports that, in 1988-89, among the 50 states, Oregon ranked 10th in overall state and local tax burden (state and local taxes as a percent of personal income). LRO recently reported that, by 1995-96 (the most recent year for which such rankings are available), Oregon had dropped to 41st.

Figure 2: Oregon's Federal Tax Deductibility Limit Over Time



D. Relevant Past City Club Positions

The City Club studied and took positions on all four ballot measures that proposed changes to the federal tax deduction.

- City Club opposed 1960 Measure 14, which would have eliminated the federal tax deduction, primarily because the anticipated revenue shortfall did not materialize and the state did not require the additional revenue.

- City Club supported 1973 Measure 1 (Governor McCall's School Finance Plan) and found that the proposed $2000 limit on the federal income tax deduction would increase the progressiveness of the Oregon income tax.

- In 1974, the City Club opposed the legislature's tax reform package (1974 Measure 1), but found that the proposed $3000 limit on the federal income tax deduction was the measure's strongest element, again because it would increase the progressiveness of Oregon's tax system.

- While, the City Club supported the far-reaching tax relief measures proposed by 1980 Measure 5, the Club did not comment or take a separate position on the measure's proposal to increase the deductibility limit to $7,000.

The City Club believes that proposed changes to Oregon's tax system should be evaluated according their impact on the overall tax system. City Club reports in 1984, 1993, and 1999, developed specific criteria for evaluating tax reform proposals. Our Committee applies these criteria to Measures 91 and 88 in the Discussion Section below.

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III. PROPONENTS AND OPPONENTS' ARGUMENTS-MEASURE 91

Measure 91 proponents and opponents presented the following arguments in favor and opposed to Measure 91. These statements are those of the measure's proponents and opponents. Our Committee does not attest to the accuracy of any facts or figures contained in the arguments.

A. Proponents' Arguments in Favor of Measure 91

- "The only way to cut spending is to not send us the money. If you send the money to Salem, we will spend it." (reported by Oregon Taxpayers United as a quote from Oregon State Senate President Brady Adams).

- Oregonians have voted three times to make federal taxes fully deductible on state tax returns. And each time, the Legislature has overruled the voters and limited the federal tax deduction.

- Placing the deduction in the Constitution will prevent the Legislature from overruling the voters again in the future.

- Oregonians pay about $440 million a year in personal state income taxes on money they never see—money they pay to the federal government as federal income taxes.

- Charging income tax on income tax—double taxation—is so unfair that even the IRS doesn't do it. Oregonians are allowed to deduct all their state income taxes (and even property taxes) on their federal tax returns.

- This measure amounts to about a 10 percent income tax cut for Oregonians and would benefit taxpayers with taxable incomes of $20,000 or more. It's a tax cut aimed squarely at the middle class.

- The state budget will increase this coming biennium by approximately $1.5 billion. Making federal income taxes fully deductible on state income tax returns will slow the growth of state government by about half; leaving enough money for state spending to increase about $700 million.

- The Legislature is offering a statutory cap of $5,000 starting in 2002, but there is no assurance that the legislature would not reduce the cap again in the future.

B. Opponents' Arguments Against Measure 91

- Measure 91 would cost $938 million in the 1999-2001 biennium, then $2.03 billion in the 2001-2003 biennium.

- Most Oregonians will never see a dime of benefit from this measure. A family of four making $47,000 a year would get a cut of only $1.66 per month. The vast majority of the tax cut (72 percent) will go to those making over $100,000 per year and corporations, to whom the measure gives an entirely new tax break.

- In its first year, Measure 91 will actually raise taxes for most Oregonians. Because it will cancel the "kicker," a family of four making less than $60,000 will end up paying more Oregon income tax than they would otherwise.

- Assuming the Legislature started to make cuts in the 1999-2001 budget as of January 1, 2000, the measure would force actual cuts of $632 million in 1999-2001. That would require a 24.4 percent reduction in state government spending during the final months of the 1999-2001 biennium.

- The $2.03 billion loss for 2001-2003 would represent 18.1 percent of the projected General Fund budget for 2001-2003. Thus, continued major cuts would be required.

- For example, based on Legislative Fiscal Office calculations, it is estimated that if the 1999-2001 cuts were made across the board, K-12 public schools would lose $266 million; higher education and community colleges would lose $81 million; health care programs would lose $77 million; senior and disabled services would lose $28 million; prisons would lose $48 million.

- Measure 91 would place inappropriate statutory tax code language into the Oregon Constitution.

IV. PROPONENTS' AND OPPONENTS' ARGUMENTS—MEASURE 88

Measure 88 proponents and opponents presented the following arguments in favor and opposed to Measure 88.

A. Proponents' Arguments In Favor of Measure 88

- Measure 88 would reduce the average family tax liability.
- Measure 88 would put more discretionary income into the Oregon economy.
- Measure 88 index the amount of federal income taxes that can be deducted on state income tax returns, eliminating revenue windfalls tied solely to increases in the cost of living.

B. Opponents' Arguments Against Measure 88

- The bulk of the Measure 88 tax cut goes to upper middle-income and wealthy Oregonians.
- The 60 percent of Oregon households in the lowest income groups will receive an average tax break that is less than $7 a year, representing just seven percent of the tax cut.
- The poorest 40 percent of Oregon households receive no tax break.
- The top 40 percent of Oregon households will average a $128 reduction in yearly taxes, or 93 percent of the tax cut in Measure 88.
- The wealthiest 20 percent of Oregon households, with an average income of about $132,000 a year, will reap 59 percent of the tax break and have their tax bills reduced by $164 on average.
- Measure 88 does not address the effect revenue reductions would have on state services.
- Measure 88 is simply an attempt by the legislature to head off passage of Measure 91 by offering an alternative. The legislature did not see a problem that needed to be fixed until Bill Sizemore filed Measure 91.

V. DISCUSSION

In this section, we discuss and analyze the likely impacts of Measure 91 and Measure 88 on state revenues, who would benefit, and how each measure would affect the overall character of the tax system. We then evaluate both measures against the City Club criteria for a balanced tax system.

A. Measure 91 and 88 Impacts

<u>Measure 91—Revenue Impact</u>

The Legislative Revenue Office estimates that Measure 91 would reduce state revenues by $938 million in the current biennium (1999-2001) and $2.033 billion in 2001-2003. Oregon Taxpayers United (OTU) takes the position that Measure 91 would only slow the rate of increase in state government but would not result in an actual reduction in resources available to fund state government functions.

Because of ambiguous wording in the measure, it is unclear when Measure 91 would take effect. Mr. Sizemore currently takes the position that Measure 91 will not affect state tax revenues until 2002 (when returns are filed for tax year 2001); he previously stated that the measure would take effect with tax returns filed for the 2000 tax year. This issue is not likely to be resolved short of litigation and/or legislative action.

The effective date is important because budgeting has already been completed for this biennium, which ends June 30, 2001. If Measure 91 takes effect in 2000—and is reflected on tax returns filed by April 15, 2001—the measure would reduce state revenue by $938 million in the current biennium. This revenue loss would be partially offset by approximately $300 million in expected additional revenue not anticipated when the 1999-2001 state budget was originally developed. Therefore, state government programs and services would need to be cut by $632 million (18.9 percent of planned expenditures) during the last 8 months of the biennium. An anticipated spending reduction of 20 percent would be required to balance the state budget in the 2001-2003 biennium. The legislature could choose to reduce the cuts by raising taxes to generate additional revenue.

If Measure 19 does not pass, Oregon's "kicker" law will require that the approximately $300 million in unanticipated revenue be returned to taxpayers. If Measure 91 passes the surplus revenue instead would be used to offset the $938 million revenue loss, and taxpayers would not receive a "kicker" tax rebate.

Another revenue effect of Measure 91 would be to shift a larger percentage of Oregon taxpayer dollars to the federal government. Because state income taxes are deductible on federal returns, a reduction in state income tax results in a higher federal taxable income and thus a greater federal income tax liability. For example, the single filer with $200,000 in adjusted gross income would experience a reduction in state income tax of $4,656, but her federal income tax would increase by $1,676. Thus, her total tax savings would be $2,980 and 36 percent (her marginal tax rate) of her state income tax savings would be paid as additional federal income tax. In effect, a portion of the Measure 91 tax cut goes not to Oregon taxpayers, but to the federal government for uses that may or may not benefit Oregonians.

Measure 91—Individual Taxpayer Impact

The effects of Measure 91 on individual taxpayers are shown in Table 1. Calculations for single and joint filers were performed by the Committee to understand how Measure 91 would benefit taxpayers with different income levels. Effective personal income tax rates under current Oregon law and as projected under Measure 91 are also set forth in Table 1. Effective state income tax rate data are also shown graphically in Figure 3 in order to illustrate the effect of Measure 91 on individual taxpayers as income increases.

Table 1: Single Filer Income Tax Changes Under Measure 91

Adjusted Gross Income	Current Effective State Tax Rate (%)	Measure 91 Effective State Tax Rate (%)	Federal Tax Change	Oregon Tax Change	Total Tax Change	Oregon Tax Change
Single Filer						
$20,000	5.80%	5.82%	$0	$0	$0	0.00%
$30,000	6.60%	6.43%	$0	-$40	-$40	-2.00%
$33,000	6.80%	6.53%	$0	-$83	-$83	-3.70%
$40,000	7.20%	6.52%	$0	-$259	-$259	-9.00%
$50,000	7.50%	6.52%	$0	-$511	-$511	-13.60%
$60,000	7.80%	6.51%	$103	-$763	-$660	-16.30%
$80,000	8.10%	6.50%	$394	-$1,270	-$877	-19.60%
$100,000	8.30%	6.48%	$556	-$1,793	-$1,237	-21.70%
$200,000	8.60%	6.31%	$1,676	-$4,656	-$2,980	-27.00%
$500,000	8.90%	5.95%	$5,748	-$14,516	-$8,768	-32.80%
$1,000,000	8.90%	5.79%	$12,407	-$31,332	-$18,924	-35.10%
Joint Filers						
$20,000	4.20%	4.17%	$0	$0	$0	0.00%
$30,000	5.30%	5.33%	$0	$0	$0	0.00%
$40,000	6.20%	5.91%	$0	-$99	-$99	-4.00%
$50,000	6.70%	6.26%	$0	-$234	-$234	-6.90%
$60,000	7.10%	6.41%	$0	-$418	-$418	-9.80%
$80,000	7.60%	6.42%	$0	-$922	-$922	-15.20%
$100,000	7.90%	6.45%	-$25	-$1,407	-$1,432	-17.90%
$200,000	8.40%	6.37%	$1,484	-$4,121	-$2,637	-24.40%
$500,000	8.80%	5.96%	$5,573	-$14,073	-$8,500	-32.10%
$1,000,000	8.90%	5.80%	$12,232	-$30,888	-$18,657	-34.80%

Note: The table reflects tax liability based on 1999 tax rates, exemption limits, standard deduction amounts, and Oregon personal income tax credits. Itemized deductions are assumed when it would be tax-advantageous to do so and include only state or federal income taxes.

As shown in Table 1, taxpayers without a federal tax liability in excess of $3,000—generally single filers making less than $30,000 and joint filers making less than $40,000—would receive no tax relief.

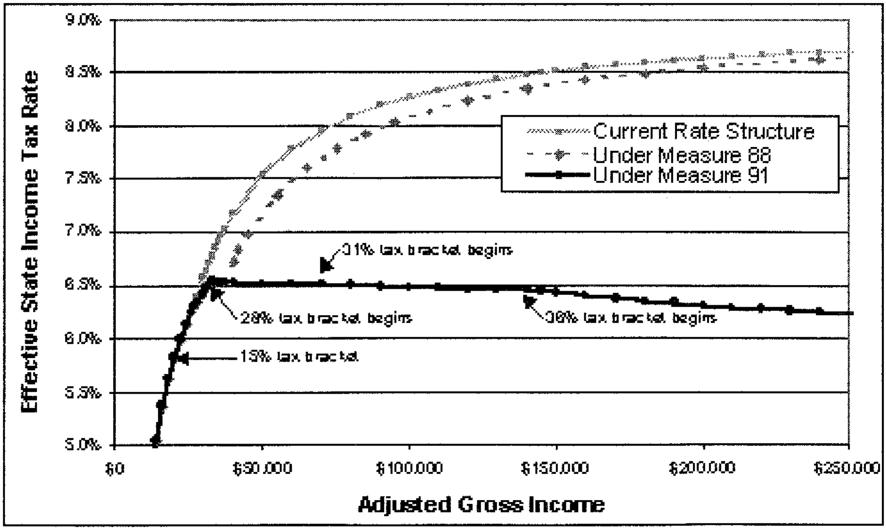
<u>**Measure 91—Structural Impact**</u>

In addition to the financial effects on state government, Measure 91 would dramatically alter the structure of the Oregon income tax. State income tax brackets have not historically been adjusted for inflation. The state income tax has become less progressive as a result because taxpayers now reach the top 9 percent income tax bracket at relatively low levels of income. Measure 91 would further alter this structure and make the Oregon personal income tax regressive at upper income levels. Figure 3 shows that one's effective state income tax rate would peak at an income level of around $33,000 and would decline as income increases.

Measure 91 would make the Oregon income tax structure regressive because the federal income tax structure is progressive. As federal taxable income increases, marginal federal income tax rates increase from 15 percent to 39.6 percent. Under Measure 91, this increase in federal income tax liability would result in a corresponding decrease in the percentage of income subject to state income tax. The current $3,000 deductibility limit counters this effect and retains progressiveness in the Oregon income tax.

By eliminating the cap, the percent of income subject to state income tax decreases as the progressive federal income tax rates increase. Calculations performed by our Committee indicate that the highest effective state income tax rate would fall on single filers with an annual income of $33,000. Higher income taxpayers get a bigger tax cut in both real and percentage terms

Figure 3: Tax Structure Changes Under Measures 91 and 88



than lower income taxpayers. This is apparent in Table 1, which shows that a single filer with $80,000 in adjusted gross income would see a state income tax reduction of about $1,270, while the same filer with $200,000 in adjusted gross income would see a state income tax reduction of $4,656. The effective state income tax rate of the $80,000 filer would be 6.5 percent; for the $200,000 filer it would be 6.3 percent.

The effect of Measure 91 on the tax structure for married taxpayers filing jointly is similar, though the income tax would become regressive at somewhat higher income levels. For this group, the effective state income tax rate stays roughly the same for those couples whose incomes place them in the 28 percent and 31 percent federal income tax brackets. As income increases, pushing filers into the 39.6 tax bracket, their effective state income tax rate begins to decline. For example, a couple with an income of $50,000 per year would have an effective state income tax rate of 6.3 percent, the same rate as a couple earning $280,000. However, a couple with an income of $1 million would have an effective state income tax rate of 5.8 percent.

Measure 91—Corporate Taxpayer Impact

For corporations, full deductibility of federal income tax would reduce the amount of income subject to Oregon's flat 6.6 percent corporate income tax rate. The Legislative Revenue Office estimates that corporate income tax revenue would be reduced by $66.1 million in the 1999-2001 biennium and $437 million in the 2001-2003 biennium. Once the measure would be fully implemented, the Legislative Revenue Office estimates that corporate income tax collections would be reduced by around 35 percent.

Similar to personal income taxpayers, corporations would have less state income tax to deduct from their federal tax returns. Because the Federal corporate tax rate is around 34 percent for most corporate income, approximately one-third of the corporate tax reduction under Measure 91 would be paid to the federal government.

Measure 88

Measure 88, which is a legislative referral, would increase the limit on the deduction of federal taxes from $3,000 to $5,000. Beginning January 1, 2003, this limit would be adjusted annually according to a cost of living index. Measure 88 would not permit corporate taxpayers to deduct federal income tax, leaving current law unchanged in this regard. Measure 88 would take effect for tax years beginning January 1, 2002.

The Legislative Revenue Office estimates that this measure would reduce revenue to the General Fund by $168 million in the 2001-03 biennium and $259 million in the 2003-05 biennium.

All Oregon taxpayers who pay more than $3,000 in federal taxes would see a reduction in state income tax. State taxes would be reduced by $180 for taxpayers with a federal tax liability of $5,000 or more. Taxpayers with a federal tax liability near the new $5,000 limit would see the greatest reduction in taxes as a percent of income. In general, this group includes single filers with an adjusted gross income of about $37,000 and joint filers with an adjusted gross income of about $46,000. Since the maximum amount of the state tax reduction is fixed at $180, the tax savings become less significant as one's income increases and the $180 reduction in state income tax becomes a smaller percentage of one's tax liability. As seen above in Figure 3, Measure 88 would retain the progressiveness in the Oregon tax structure.

B. City Club Tax System Criteria

City Club has adopted six criteria for evaluating tax proposals: fairness, sufficiency, certainty, efficiency, neutrality, and clarity. This research committee used these criteria to examine Measures 88 and 91.

Fairness

City Club definition: Fairness is predicated on two equity concepts: ability to pay and benefits received. Regarding ability to pay, as taxpayers derive greater economic gain from work and assets, they contribute a higher percentage of that gain in taxes. Taxpayers who derive similar economic gain from their work and assets pay similar amounts in taxes. Taxpayers who receive special benefits from facilities or services supplied by the government are subject to taxes or fees on those benefits.

What this means is that the City Club supports a progressive tax system over a proportional (flat tax) or regressive system. Taxpayers who have similar incomes should generally pay similar amounts in taxes. Individuals, organizations, or companies that receive special benefits from government services or facilities, in general, should pay for those benefits through targeted taxes, fees or charges.

Measure 91: This measure does not meet this definition of fairness because individuals with a greater economic gain (and, hence, a greater ability to pay) actually will contribute a lower percentage of that gain in taxes (regressive taxation). A married couple with a $40,000 income would pay 5.9 percent of that income in state taxes, roughly the same percentage as a couple with a $500,000 income. The tax rate would peak at 6.45 percent for joint filers earning about $100,000 and would decrease thereafter, with earners of $1,000,000 paying an effective state income tax rate of 5.8 percent. (See Table 1 above.)

Measure 88: This measure maintains the principle that as taxpayers derive greater economic gain, they contribute a higher percentage of that gain in taxes. For married couples filing jointly the percentage of state tax paid increases from 5.3 percent at the income level of $30,000 to 8.9 percent at $1,000,000. Married taxpayers earning $30,000 or less receive no relief. (See Figure 3 above.)

Sufficiency

City Club definition: The tax system should produce an adequate flow of funds to pay for public services established by law.

Measure 91: During the 2001-03 biennium, the General Fund will be reduced by $2 billion as estimated by the Legislative Revenue Office, requiring an 18.1 percent reduction in General Fund expenditures unless new taxes are raised and/or Oregon experiences a dramatic and sudden economic surge. Education, public safety and human services account for about 94 percent of the General Fund expenditures. A cut in the General Fund of necessity would cut services in these three areas.

OTU appears to disagree with analysis of the Legislative Revenue Office, stating that the cut would be only about $800 million. However, OTU did not respond to your Committee's request for data to support these figures. Moreover, even if the OTU estimate were accurate, an $800 million reduction in the current service level would be dramatic.

Measure 88: This measure reduces state revenues by $168 million during the 2001-03 biennium. Some program reductions under this measure would be necessary. The measure does not attempt to allocate these reductions among existing programs.

Certainty

City Club definition: The tax system is subject to few changes over time and produces a level of revenue that is reasonably predictable.

Measure 91: Structural certainty would be increased since Measure 91 is a constitutional amendment. The legislature could not limit the deductibility of federal income taxes.

Measure 88: Since this is a statutory change, the amount that can be deducted and the use of indexing could be changed by an act of the legislature. The revenue stream would be as predictable as the current system.

Efficiency

City Club definition: Compliance, collection and enforcement costs are kept to a minimum to facilitate taxpayer reporting and revenue administration. Enforcement is consistent and even-handed. The state tax system works in concert with the federal system.

Measures 91 and 88: There would be no change in efficiency from the current system.

Neutrality

City Club definition: The tax system produces neutrality among economic activity by minimizing interference in private economic decisions. It does not adversely affect the ability of businesses within the state to compete with the businesses of other states.

Measure 91: The private economic decisions of a number of Oregonians could be affected. The reduced income tax burden may encourage Oregonians living in the Portland area to stay in Oregon when they might otherwise have moved to Washington to avoid Oregon income taxes. Oregonians may also be negatively affected by the need to privately pay for services currently paid for through the income tax. For example, a diminishing of the quality of schools could result in some Oregonians choosing to pay tuition for private schools. The Oregon Health Plan may need to be dismantled, leaving 80,000 Oregonians without health insurance.

Measure 91 could enhance the ability of businesses to compete with businesses in other states since the tax burden of businesses would be reduced.

Measure 88: This measure does not interfere with private economic decisions. It has no immediate apparent affect on the ability of businesses to compete with businesses in other states since Measure 88 does not change taxes paid by corporations.

Clarity

City Club definition: How the Oregon tax system functions, and proposed changes to the system, are described clearly and simply, in terms understandable and debatable by Oregon citizens.

Measure 91: Some confusion exists over the meaning of the language concerning which year the measure would become operative, a matter which will need to be clarified by the courts or the legislature. However, once that matter is settled the measure is simple and straightforward.

Measure 88: The measure appears to be clear and straightforward and should present no problems for the Oregon taxpayer to understand.

Application of Criteria to Specific Arguments

After examining the City Club criteria for taxes, your Committee found three areas that were particularly relevant for understanding the impacts of both measures. These were fairness, sufficiency and certainty.

Fairness. In some ways Measure 88 appealed to the Committee members concerning the issue of fairness. Measure 88 would index the level of deductibility of federal income taxes. Indexing would mitigate to some degree the increase in taxes individuals pay to the state just because of inflation.

As for Measure 91, OTU describes the current system as "unfair," stating that "charging income tax on income tax" is "double taxation." Setting tax rates is always a contentious issue. There is nothing in the City Club criteria for fairness that would lead to the conclusion that full deductibility is or is not fair. Your Committee does not accept the basic premise that it is inherently unfair to limit the deduction for federal income tax payments.
Rather, in the Committee's view, progressiveness (the principle that those with greater incomes should pay a higher percentage of their income in taxes) is a more appropriate test of fairness than any single mechanical detail in the tax structure. By limiting deductibility of federal taxes paid, the state creates a higher effective tax rate for those with higher incomes, injecting an element of progressiveness in Oregon's otherwise relatively flat income tax rates. Measure 91 would remove this source of progressiveness and, in the Committee's view, is clearly unfair. Every couple earning more than $200,000 a year would pay a lower percentage of their income in state taxes than those earning $60,000 a year. Even if tax relief is an important goal (a questionable proposition given the current condition of the state budget), your Committee believes that progressiveness should not be sacrificed in pursuit of that goal.

Mr. Sizemore's advocacy is disingenuous at best in claiming that all taxpayers with incomes over $20,000 will benefit from Measure 91. First, your Committee's calculations indicate that a tax reduction would not apply until individual filers reach income levels of about $30,000. Joint filers must have about $40,000 in income before they would realize a tax reduction. Second, even if it is literally true that middle-income taxpayers will see some tax reduction from Measure 91, any savings are nominal at best. Truly significant tax reductions are reserved for taxpayers earning substantially more. For example, the tax cut for a family of four with $50,000 in income would be about $65 per year (LRO Research Report, June 22, 2000). This amount would almost certainly be overwhelmed by higher charges for government services necessary to make up for a tax reduction benefiting mostly higher-income taxpayers.

Your Committee could find no reason for changing the law to allow corporations to fully deduct their federal income taxes. Given that individuals already shoulder the vast majority of the Oregon tax burden, the Committee does not support even heavier reliance on individuals for tax revenues.

Currently, corporate income taxes represent 8 percent of state income taxes while personal income taxes comprise the remaining 92 percent. Although both individual and corporate taxpayers would see a tax reduction, corporate income tax revenues would decrease by a larger percentage. The Legislative

Revenue Office estimates that once the measure is fully implemented, personal income tax revenues would be reduced about 16 percent while corporate income tax revenues would decrease around 35 percent. Thus, Measure 91 would disproportionately benefit corporate income taxpayers and shift the state income tax burden further toward individual taxpayers.

Sufficiency. The impacts of Measure 88 on tax collections—at least compared to Measure 91—are not particularly severe. However, the Committee questions whether this is an auspicious time to be cutting state tax revenues. State revenues per capita have fallen from 8.36 percent in 1990 to 7.27 percent in 1999, largely due to per capita decreases in property tax revenues. Schools, which are now dependent on taxes from the general fund, have been particularly hard hit by the change in the state's taxation structure. When the legislature passed Measure 88 it did not have a plan to deal with a revenue shortfall. Program cuts simply will have to be made if this measure passes.

The impacts of Measure 91 are, without a doubt, very serious. Services would have to be cut in those areas supported by the general fund (education, public safety, and human services). The loss of revenue cannot be spread across the entire state budget because funds outside the general fund are dedicated for specific purposes. The General Fund for the 1999-01 biennium is currently $10.157 billion. According to the Legislative Revenue Office, passage of Measure 91 would eliminate the state income tax "kicker" and would result in a General Fund shortfall of $632 million this biennium if it were to go into effect immediately. In the next biennium, general fund revenues would be reduced by just over $2 billion, requiring a spending cut of nearly 20 percent.

Figures from OTU state that the impact of Measure 91 would be about $800 million. Our Committee attempted to obtain details on OTU's estimates of the budgetary impact of Measure 91. However, OTU did not respond to inquiries about the discrepancy between their estimates and the estimates of the Legislative Revenue Office. Other knowledgeable sources were not able to determine how the OTU figures might have been generated. The Committee asserts, however, that even if the OTU's figures are correct, the impact on state services would be extremely serious.

Some have argued that there is no reason to be concerned about the projected revenue shortfall because the impacts of 1990Measures 5 and 1996-7 Measures 47/50 were not as serious as initially projected. Oregon was able to adjust to the change in tax structure because of a dramatic increase in income tax revenues due to population growth and a booming economy. However, there do not seem to be any prospects for another dramatic rise in income tax revenues either through population growth or another economic boom. Likewise, legislators have testified they are not able to identify a new source of tax dollars (such as a sales tax) that would be accepted by the general public. It is somewhat ironic that the proponents of Measure 91 lament the increase in income tax revenues without acknowledging that the dire predictions of opponents to Measures 5 and 47/50 would likely have come true in the absence of this very same increase in income tax revenues.

Certainty. Measure 91 would increase certainty since it is a constitutional amendment. While certainty at some level is a desirable goal, restricting the legislature's flexibility to raise revenues is not. The legislature has used the ability to change the deductibility of income taxes over the years as a way of adjusting income tax receipts in response to changes in the economy. The Committee has deemed it unwise to reduce the legislature's ability to respond to economic conditions.

C. Appropriateness of Constitutional Amendment

Finally, your Committee was concerned about the continuing presence on the ballot of measures in which no connection is made between the taxes that Oregonians are asked to pay and the services that will be effected by changes in revenues received by the state.

Measure 91: City Club has consistently opposed cluttering up the constitution with measures of this kind. Specifically, the City Club has a position that initiated amendments to the state constitution should "relate only to the structure, organization and powers of government, and the rights of the people with respect to their government...." The position is based on the City Club's 1996 report, *The Initiative and Referendum in Oregon.*

The 1996 report found that the initiative process is being used inappropriately "to place ordinary statutory matter into the Oregon Constitution to prevent legislative change and to preclude judicial review for consistency with the Oregon Constitution."

Measure 91 clearly conflicts with the Club's position. Measure 91 would put language into the Oregon Constitution that can be and should be dealt with in the state's statutory tax code. Measure 91 proponents have stated that they are doing this precisely to prevent future changes by the legislature.

Measure 88: Measure 88 is a statutory amendment to the existing tax code and meets the Club's criteria.

VI. CONCLUSIONS

Measure 91: Our Committee is unanimously opposed to the passage of Measure 91 for the following reasons:

1. The measure is fiscally irresponsible. It would require cuts of about $2 billion per biennium in an already strained General Fund budget. As a point of reference, the entire public safety budget for the 1999-2001 biennium is $1.5 billion. The proponents of the measure do not address where or how those budget cuts could or should be made; without supporting data, they simply deny the cuts will occur.

2. Lower and many middle income taxpayers realize no tax reduction from this measure.

3. The measure allows corporations to fully deduct their federal income taxes, which has the effect of shifting the tax burden from corporations to individual taxpayers.

4. The measure is regressive, with highest income taxpayers paying a lower effective tax rate than less affluent taxpayers.

5. Proposing what amounts to a change in the tax code as a constitutional amendment is an abuse of the initiative process. The Oregon Constitution should be a statement of broad principles.

Measure 88: Our Committee is unanimously opposed to the passage of Measure 88. While indexing the amount of federal income tax that can be deducted has some appeal, cutting revenues to the state at this time is unwise. This measure appears to be addressing a political rather than fiscal problem. In addition, lower and many middle income taxpayers would realize no benefit from this measure.

VII. RECOMMENDATIONS

Your Committee unanimously recommends a NO vote on Measure 91.

Your Committee unanimously recommends a NO vote on Measure 88.

Respectfully submitted,
Jeannie Burt
Jon Hart
Tim Hemstreet
Jeff Knapp
Carolyn Bullard, chair

Pauline Anderson, research advisor
Paul Leistner, research director

VIII. APPENDICIES

A. WITNESS LIST

Lizbeth Martin-Mahar, analyst, Legislative Revenue Office
Jeff Merkley, Oregon State Representative; member, Measure 91 Explanatory Statement Committee
Becky Miller, Oregon Taxpayers United
Steve Novick, executive director, Center for Constructive Citizen Action
Ken Strobeck, Oregon State Representative; chair, House Revenue Committee
Ed Waters, analyst, Legislative Revenue Office
Kurt Weber, Cascade Policy Institute
Dick Yates, analyst, Legislative Revenue Office

B. RESOURCE MATERIALS

City Club of Portland:
"Both Sides of Graduated Income Tax Given" *Bulletin*, July 28, 1922.
"Personal Income Tax Bill (State Ballot Measure No. 14)," *Bulletin*, October 28, 1960.
"Property Tax Limitation: School Tax Revision (State Measure No. 1 in special election May 1, 1973)", *Bulletin*, April 20, 1973.
"Income, Corporate Tax and School Support Increase (State Measure No. 1)," *Bulletin*, May 24, 1974.
"A Review of Property Taxation in Oregon and Report on State Measure No. 5 Continues Tax Reduction Program," *Bulletin*, April 14, 1980.

Committee for OUR Oregon. Campaign materials. (www.ouroregon.org).

Steve Novick:
· Memo to Explanatory Statement Committee for Initiative 10/Measure 91, August 1, 2000.
· Memo to interested parties regarding definition of "paid," August 1, 2000.

Oregon Center for Public Policy. "Helping the Top: SB 537-A Provides an Upper Middle Class Tax Cut," May 25, 1999.

Oregon Legislative Revenue Office:
· "Initiative Petition #10: Full Deductibility for Federal Income Taxes," June 22, 2000.
· "Basic Tax Packet," July 1999.
· "Revenue Impact of Proposed Legislation 1999 Regular Session, Bill Number SB 535B," July 10, 1999.
· Memorandum from E.C. Waters, economist to House Revenue Committee, regarding Federal Tax Subtration, January 18, 1999.

Oregon Legislative Fiscal Office. "Budget Highlights: Legislatively Adopted 1999-2001 Budget," August 1999.

Oregon Secretary of State. Measure 91 and 88: text, ballots titles, explanatory statements, fiscal impact statements, September 2000.

Oregon Tax Payers United. "Full Deductibility of Federal Income Taxes" (www.otu.org/pages/fulldeductibility.htm) (printed August 4, 2000).

The Oregonian:
· Mayer, James. "Sizemore says tax cuts would come on '01 taxes," August 2, 2000.
· Editorial. "Lowering the sky, and the state," June 25, 2000.

The Tax Foundation. Ranking of tax burdens posted on Foundation website at www.taxfoundation.org.

U. S. Department of Commerce, Bureau of Economic Analysis. "Comprehensive Revision of State Personal Income," published in Survey of Current Business, June 2000.